RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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June 6, 2001 **LETTER 1319**

May 18, DJIA 11301.74; PTI 5300; A-D Ratio –2.52
May 25, DJIA 11005.37; PTI 5298; A-D Ratio –2.58
June 1, DJIA 10990.41; PTI 5303; A-D Ratio –2.56
***Dow Times Book Value: +6.71**
***Gold 34-day MA: 271.60 Dow yield: 1.62; Dow p/e: 23.5**

NON-CONFIRMATION: I've been watching the action of the D-J Averages with interest. There's a serious non-confirmation now in force, and it could be significant -- the more so since nobody else has been talking about it or even noticing it (see chart below).

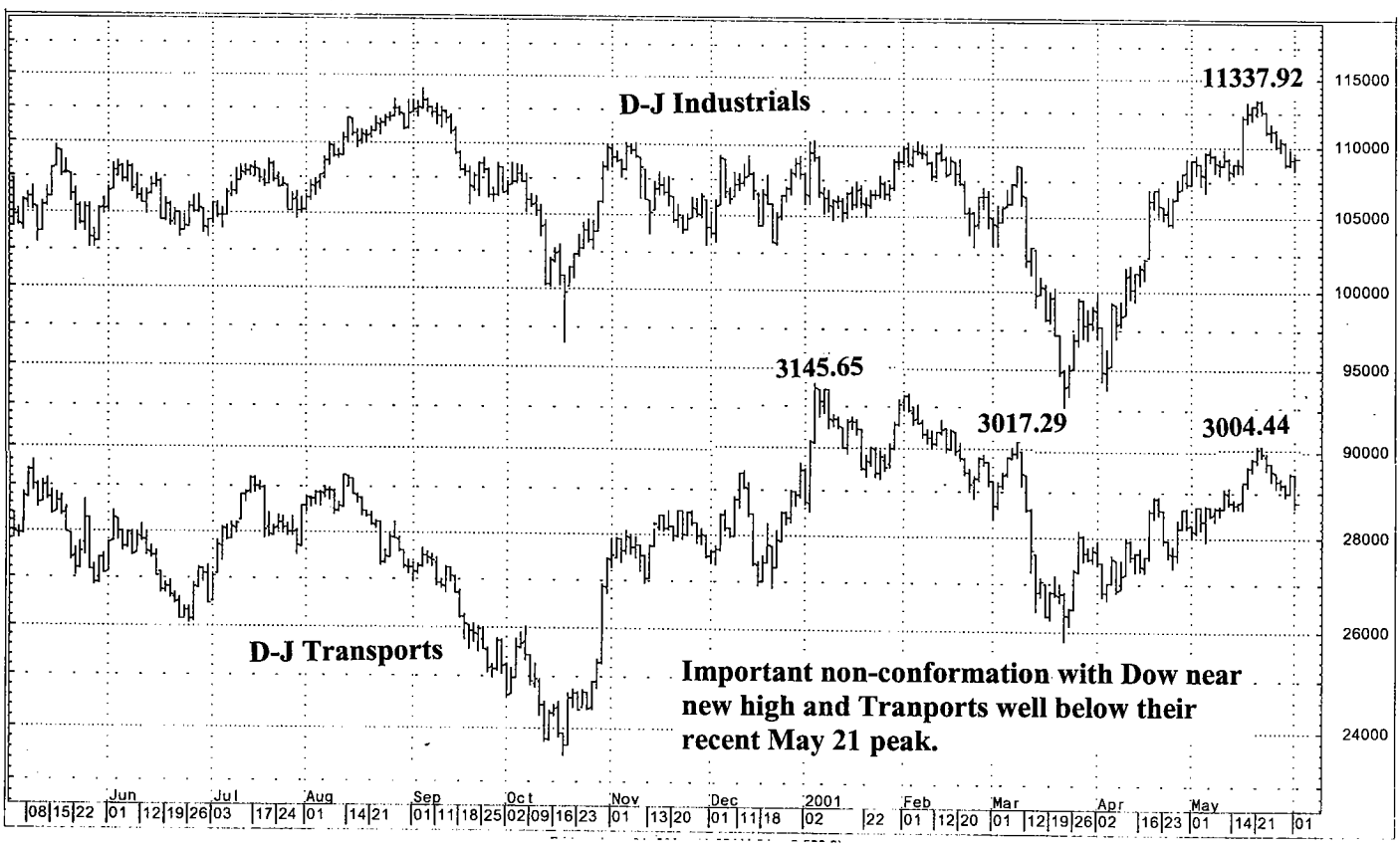
Note that the Dow on May 21 closed at a recovery high of 11337.92, which was above all Dow peaks going back to the January 2000 all-time high. But the Transports on the same day, May 21, halted their advance at 3004.44. This was far below their January and February peaks, and below even their nearby March 8 peak of 3017.29.

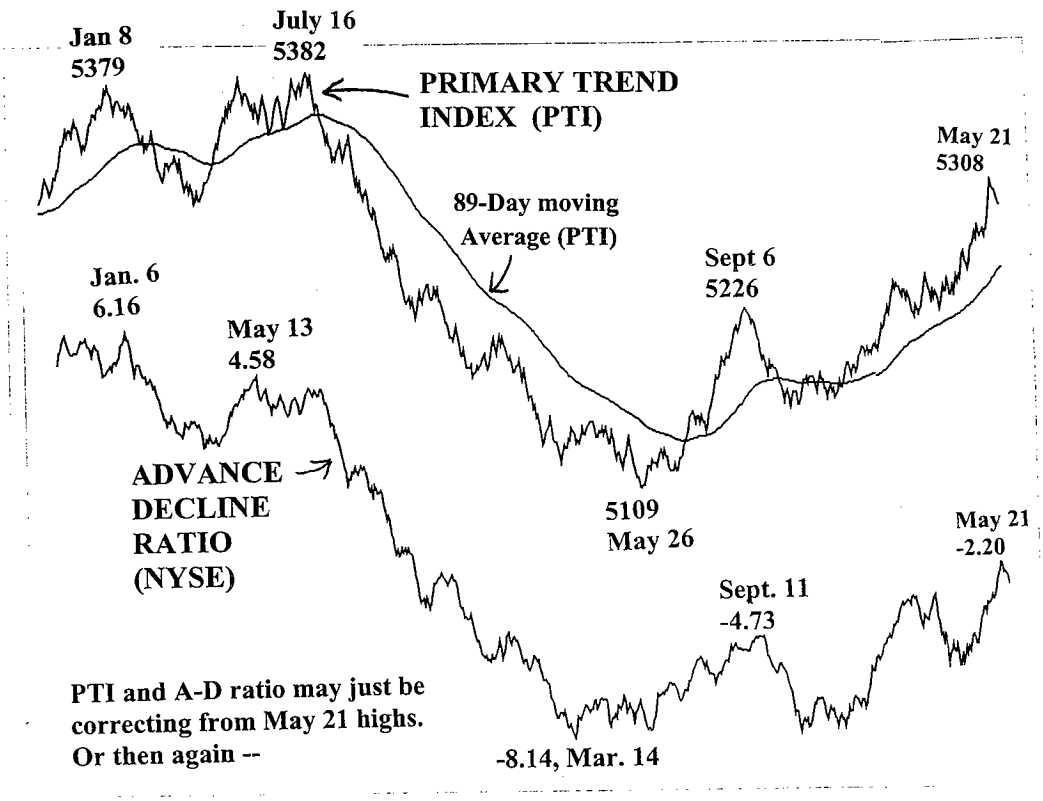
Thus, as this is written we have a flagrant non-confirmation between the Dow and the Transports. This is a technical "discrepancy" that will have to be addressed.

Remember, Transports represent the nation's sales, shipping and travel. If the Dow (representing manufacturing) makes the goods, unless those goods are sold and shipped out, the path ahead spells trouble.

THE PICTURE: I recently read a piece about an advanced investment class given at a university. A famous and very wealthy investor was invited to address the class. This gentleman talked for two hours about his investment techniques and the methods he used to arrive at riches.

At the end of the lecture, as the speaker was leaving, one student rose to ask a question: "Sir, you've been fantastically successful -- if you were to provide us with one concept that might send us on the road to wealth, what might it be?" The class was almost embarrassed by this seemingly naïve question.





The speaker halted for a moment, then issued a two word answer, "Don't lose."

I've been saying this same thing for years. Of course, what the speaker meant was – don't take the big loss. Big losses are killers for any investment program. Take a 50% loss in your portfolio, and you've got to better than double your money in order to break even. I should say "more than" double because of taxes. Chances are that if you take a 50% loss, you'll be so demoralized that you may never "get back to even again."

The main problem with the current market is that it's flagrantly overvalued by classic analytic methods. This market (S&P 500) is selling at price/earning ratios of over 25, and it pays little or no dividends. That leaves the average investor depending totally on rising prices in an extremely expensive market.

An expensive market is a high risk market. To my mind, the only time buying a high risk item is justified is if the high-risk investment pays a very fat return for the risk. In other words, a "junk bond" paying 16% may be worth the risk. At 16% money doubles in less than five years, and if you buy a bond that you believe is basically viable -- then considering the 16% return, the bond may be worth the risk.

How about buying a list of stocks selling at 25 times earnings and paying out 1% in dividends on average? That, by the way, is about what you'd be doing if you bought a list of maybe twenty stocks today.

Would buying those twenty stocks be worth the risk, a risk that they might head down, in which case you could find yourself "locked in with no income?" To my mind the answer is "no," it would not be worth the risk.

So what do you do today that makes sense? You can buy short-term government paper and just wait. You can buy bonds on the thesis that sooner or later the bear market will lead to recession and lower rates all around. And at the bear market bottom you should be able to buy stocks at great values. When that happens you can sell your bonds (interest rates will probably be low by then) and switch to stocks. Or you simply compound your bond income over the years.

But all of this takes patience and a long-range view. You've got to have a plan that makes sense, and you've got to stick with that plan.

Against the above, you hear a lot today about buying stocks and "holding for the long haul." To me that's not a plan, it's a hope. Everything is timing. Buying stocks when they are cheap and holding those stocks for the long haul makes a great deal of sense. Buying stocks when stocks are expensive and holding for the long term does not make sense. In the long haul, holding

expensive stocks is a losing proposition. If you hold expensive stocks for the long haul, you'll be lucky in the coming ten years to break even.

BLOOMBERG: *Bloomberg* magazine, Personal Finance, I find, is one of the best all-around magazines for ideas, concepts and generally useful information.

The cover article in the current issue is "Ten Lessons Poker Teaches Great Investors." Included in the "ten lessons" are titles including "When you have the best of it, make the most of it," and "It often pays to pass," and "Examine your motivations for playing."

The last one, "Motivations," is one that all subscribers should ponder. Here are a few quotes: "The main reason for investing or playing poker is to make money, period. If poker is your way of socializing, you need to decide how much you are willing to lose and stick to that limit. If what you're after is a thrill, you need to get help. In the market, too, some people play so they can brag about wheeling and dealing with the big guys, while others just crave the excitement of trading. Investing is for a secure future. These people should find less risky hobbies like skydiving.

"Playing the market, of course, is not the same as playing cards. But in both fields, you can be more of a gambler or more of an investor."

And from the paragraph entitled "Patience: Warren Buffett has said that money flows from the impatient to the patient. That goes for poker as well as investing. In both you'll suffer dry spells. But if you stick with a strategy you know is sound, eventually you'll carry the day."

Subscribers know that in these reports I am not a gambler, I am an investor both in what I write and in the way I handle my own money and my family's money. My approach requires a lot of patience and a lot of passing. If the values aren't there, if the dividends aren't there, I will usually pass.

On the other hand, I have tons of patience. I understand the mathematics of compounding. In fact, my "bible" of investing is the book of compound interest tables. There are only two major forces that I believe put you on the road to wealth in the securities markets. The first is the power of the primary trend of the market. The second is the power of compounding.

The power of the primary trend is not always available. This is because there are bull markets and there are bear markets. There is no more powerful wealth-builder than buying early in a new bull market and riding the primary trend as the market and probably 80% of the stocks head higher.

The power of compounding is always available, always there. It's simply a question of whether the investor is willing and able to harness it.

INVESTMENT POSITION:

The post-war corporate dividend payout averaged 50%. In other words, corporations paid out half of their profits in dividends. No more, at present the dividend payout has dropped to an all-time low of 32%. The theory (espoused by corporations) is that dividends paid out to stockholders are taxed, but corporations can better use the money to create more profits and thus boost the price of their stocks. That's the theory.

Currently, the stock-buying public has gone along with the "no dividend" thesis. Look over any publication's list of stocks, and you'll see few if any dividends. The list emphasizes growth, growth, growth.

So the question becomes, who will do better with the cash, the stockholder or the corporation? The current fashion is to believe that companies can do better with their cash than just paying it out to stockholders. I totally disagree. Personally, I insist on dividends. I insist because I view investing as a compounding business, and if there are no dividends there's no way to compound your money.

The S&P 500 currently pays out $15.72 in dividends, down from a high of $17 on June 9, 1999. The current dividend amounts to a yield of 1.23%. The all-time low was 0.93% on Sept. 22, 2000.

Back in the 1920s and thereafter, companies had to pay out higher stock dividends than those available on bonds. Investors expected to be paid extra for the higher risk of stocks over bonds. That changed after World War II, when investors became more interested in rising stock prices.

But because of poor markets, investors became interested in dividends again during the 1970s. Starting in the 1980s (rising stocks) investors became less interested in dividends and increasingly fascinated with rising stock prices and capital gains. That led to the current very thin dividend yields, 1.61% for the Dow, 1.23% for the S&P 500 and 1.07% for the S&P Industrial Average.

The turning point for dividends occurred in 1968. At that time 66% of all non-financial non-utility companies paid a

dividend. Four years later the dividend yield on the S&P was 6%. But the number of companies offering dividends was already dropping. Now only one-fifth of the non-financial, non-utility companies bothers to pay out dividends.

What about the period ahead? My prediction is that as capital gains become harder to garner, dividends or INCOME will become more desirable. And those who find themselves sitting, month after month, year after year, with dividend-less stocks that are failing to advance, will find that they are sitting with "dead wood," stocks that offer nothing in the way of capital gains or dividends. Hardly an appetizing choice.

NOTES & QUOTES: Is the Fed "flipping out" in its frantic effort to control the stock market and the economy? Here's a recent record: In 1999 -- three rate increases from 4.75 to 5.50. In 2000 - three increases from 5.50 to 6.50. In 2001—five decreases in five months from 6.50 to 4.00. That's six rate increases within two years and then a quick reverse and with five decreases of a fat 0.5% each. Gimme a break, do these guys know what they're doing? And wouldn't we be better off without them?

I've warned that the upward corrections in bear markets can be violent and can come without warnings. For proof I'm indebted to a study by Paul Macrae Montgomery of Legg Mason, Wood Walker, Inc.

Paul lists the ten largest one-day percentage advances in the Dow and the ten largest in the Nasdaq. I show these 20 day moves in the two boxes below.

But what's so amazing, is, as Montgomery puts it, "... that 18 out of the 20 of the greatest gains of all time came in the midst of the two worst bear markets of all time." Of course, Paul's referring to the bear market of 1929-32 and the Nasdaq bear market of 2000-2001.

Largest One Day % Advances In The Dow

Date	Price Move	% Change
10/6/31	12.86	14.9 %
10/30/29	28.4	12.3
9/21/32	7.67	11.4
10/21/87	186.84	10.2
8/3/32	5.06	9.5
2/11/32	6.8	9.5
11/24/29	18.59	9.4
12/18/31	6.9	9.4
2/13/32	7.22	9.2
5/6/32	4.91	9.1

Record One Day NASDAQ % Up Moves

1/3/01	14.2 %
12/5/00	10.5
4/5/01	8.9
4/18/01	8.1
5/30/00	7.9
10/13/00	7.9
10/19/00	7.8
12/22/00	7.6
10/21/87	7.3
4/18/00	7.2

* *

Euro: In the first week of 2002 German banks alone will be circulating 71,500 tons of new coins and 2.5 billion of new bills. German banks and retailers will have to handle the withdrawal of 28.5 billion of old mark coins, weighing some 100,000 tons or nine times the weight of the Eiffel Tower.

Germany is mounting a massive campaign aimed at persuading people to empty their pockets, their mattresses, their piggy banks and their hoard of pfennigs - and take them to the bank for exchange. TV, radio, newspapers and magazines will hear Bundesbank President Welteke urging Germans to make the exchange. In Italy a Euro-Circus spreads the word from town to town. The sentiment is "Germans hate to give up their beloved D-mark, but they have to prepare for the change."

* *

Bush to California on energy - "Drop dead - you're on your own." But the energy situation is very interesting. This from *US News and World Report*: "Construction this year is slated to set a record for new power generation. A March report by the firm, Energy Ventures Analysis, found that power units already in operation or under construction will add 51,805 megawatts in 2001, enough to power half the homes in the nation. Utilities and generators have announced plans for equally ambitious additions for 2002 through 2004. According to filings with the EIA, the electricity industry expects to build 1,453 new power units from 2000 through 2004. Taking time off for weekends, that amounts to just over one new plant a day for five years running. Not all of the planned additions will be built. But if even just half go up, consumers will be cranking their air conditioners, not sweating blackouts.

"The power plant glut won't end the nation's electricity woes. Electricity travels through transmission lines, and several power grids contain bottlenecks that are expected to fuel crippling blackouts this summer in California, and perhaps in parts of the Pacific Northwest and New York City. But within a couple of years, the threat will no longer be."

* *

Big Bucks: Tiger Woods is asking $2.5 million for appearances at major golf tournaments – and he's getting it. As one pro said, "There's Tiger, and there's everybody else."

* *

Whenever a new law is proposed, I immediately calculate how it might affect the congressional crowd. The estate tax is interesting. The majority of the House and the great majority of the Senate is populated by the well to do with many being millionaires. It's obvious that most of these wealthy citizens would benefit from a removal of the estate tax. And sure enough, the estate tax will be history – but as usual it will be jettisoned over a period of years.

The estate tax was installed in 1916. I've aways detested this tax. Why should we be taxed our whole life on everything we make, and then upon our death all our savings be taxed again? It's ridiculous, so R.I.P. estate tax. I wish they would elimininate the whole unfair tax today, but as usual, nothing is done cleanly and quickly in Washington.

* *

The old "nuclear family," a married couple with a few kids -- is no longer the normal in the US. In two generations it has plunged from one in two to one in four. Thus 75% of US households are people living alone or with only one parent taking care of the children – or couples, straight or gay – or hanging out together or "hooking up."

On top of that, couples are splitting at a greater rate than ever before. Also, there are more people living alone than ever before. Interestingly, a poll told us that 90% of the men said they would marry the same woman again, but only 50% of women said they'd marry the same man again. With women increasingly in the workplace, women no longer put up with men they can't stand. As a father of four daughters, I'm all for women leaving "impossible" men.

* *

Shahid Javed Burki, former World Bank official and CEO of Emerging Markets Partnership, a Washington consulting firm, has something to say about future economies. In a recent talk to executives of AIG, Burki predicted that by 2025 China will have the largest economy in the world and the US will be in second place.

Last year the US, with an $8 trillion GDP, accounted for about 22% of the global economy. The European Union contributed another 20%. "If the present trends continue," said Burki, "over the next quarter century, we will see a fundamental reordering of the positions of the large economies." China's share will increase to 26%; the US will stay the same at 22%. India, which is now only 6%, will increase to 13% in 2025, making India the third largest economy. Japan and Germany will be fourth and fifth. Brazil and Mexico will be sixth and seventh, both overtaking Britain. "China and India will amaze the world in 2025 – together they will increase their share from only 16% in 2000 to nearly 40% in 2025. In other words, China and India will increase their share until they will be comparable to today's output of the US and Europe.

* *

Europeans' interest in organized religion or in religion at all is fading. In Britain and France, less than 10% of the population attend church as often as once a month. In Scandinavia, less than 3% of the population attend church. In Amsterdam, the Dutch Reformed is converting churches into luxury apartments to pay its bills.

Europe's loss of religious faith is in striking contrast to the situation in the US. Depending on how the question is asked, up to 95% of Americans say they believe in God. In much of Western Europe, the figure is closer to 50%. Europeans tend to be amused or surprised when US politicians end a speech with the words, "God bless America." "When they hear that, the intellectuals break out in a little smug smile," writes Jonathan Freedland (columnist for the *London Guardian* newspaper). "It's almost impossible to imagine a Prime Minister saying 'God bless Britain' or 'God bless Sweden'."

However, corruption in business and government seems to occur at similar rates on both sides of the Atlantic.

* *

California's Indian casinos are projected to earn more than $5 billion this year, which will leave the state second only to Nevada in gambling income. Furthermore, California's new gambling commission suggests that the tribal casino industry in on the cusp of overtaking Nevada. "We're just starting," said Robert Traverso, the commission's interim executive director. "The magnitude of this thing is enormous. People are only beginning to understand that."

The commission based its projections on slot-machine profits, which typically generate 80% or more of casino earnings. Sixty-one California tribes have signed contracts with the state, which permit them to operate casinos with up to 2,000 slots each. Of those, 47 tribes have opened casinos. The tribes estimate that each slot averages $300 to $350 in profits per day. **Russell Comment**: As I've long predicted, California will be the number one gambling state in the nation. Coming up next: Internet gambling, it's happening.

ENDOWMENTS: There's nothing a college or university loves more than a fat endowment. Large endowments allow colleges to give scholarships, to do research, to bring in top professors, and to provide a cushion against hard times.

Here's a list of the colleges with the largest endowments and their changes in assets over the ten years from 1990 to 2000.

By the way, with Stanford having $8.65 billion in their endowment, it's no wonder that their bonds are rated AAA on their own, without insurance (only three bonds in California are rated AAA).

Colleges cushioned by cash

The USA's wealthiest colleges and universities enjoyed strong returns on their endowments in the fiscal year ending June 30, 2000. The figures don't reflect the recent volatility in the economy; institutions hope big gains in recent years will cushion them against hard times.

College	2000 (billions)	% change 1990-2000	Per student
Harvard	$18.84	32.2%	$778,241
Yale	$10.08	40.1%	$914,398
U of Texas system	$10.01	23.2%	$67,063
Stanford	$8.65	44.0%	$478,321
Princeton	$8.40	29.8%	$1,304,053
MIT	$6.48	51.0%	$649,369
U of Calif. system	$5.64	30.7%	$31,611
Emory	$5.03	12.4%	$445,607
Columbia	$4.26	17.3%	$201,444
Wash. U/foundations	$4.23	12.6%	$350,314
Texas A&M system	$4.21	12.3%	$46,451
U of Chicago	$3.83	38.6%	$318,630
U of Michigan	$3.47	37.3%	$91,644
Cornell	$3.44	19.8%	$180,691

Greenspan's Picnic is History -- One of the most interesting results of the Senate's turning Democrat will involve the Fed. With the Senate now in Dem's hands, Texas Senate Banking Committee Phil Gramm is out as head of the Committee and Democrat Paul Sarbanes of Maryland will be the new Banking Committee head.

Gramm worshipped Greenspan complimenting him at every turn. In his appearances in front of the Senate Banking Committee, Greenspan was hosted, toasted and treated as visiting royalty.

That's going to change. Paul Sarbanes is anything but a Greenspan fan, and he will be taking on the Fed chief at every turn. Look for Democrats to subject the hallowed Greenspan to a host of tough questions and criticisms. The Greenspan picnic at the Senate hearing is over.

VALUES: The story below on values appeared on my June 1 Internet site. This story is so important than I wanted to repeat it for those subscribers who do not get on the net.

One of the most basic concepts for investors is simply **VALUES.**

Values, of course, are the very basis of Dow Theory. The Theory stipulates that you buy stocks when they are great values (which is where they are at a bear market bottom). Then you hold those stocks through a bull market -- and you sell those stocks when they become overvalued.

How do we gauge values? One classic method is to compare the earnings yield on the S&P 500 (earnings divided by price) with the yield on AAA corporates. The earnings yield on the S&P 500 is currently 3.87. The yield on AAA corporate bonds (ten year maturities) is 6.01%. On this measurement, stocks are now selling at 35% over value. Knock off 35% from the S&P and this is where stocks should be selling.

Prior to 1997 the earnings yield for the S&P 500 was almost always higher than the AAA corporate bond yield. This was a reflection of the risk premium for holding stocks rather than bonds. Since 1998, however, the surge in stocks put the earnings yield on stocks **below** the AAA corporate bond yield. This told us that the market was actually putting a risk discount for holding stocks -- rather than a risk premium.

At market peak in March 2000, the earnings yield on stocks was 3.4%, which was a huge 1.8% below the yield on AAA corporate bonds. That was enough to put a top on stocks.

But wait – today the yield on AAA corporate bonds is 6.01% while the earnings yield on the S&P 500 is 3.87. Thus today the AAA corporate yield is 2.14 ABOVE the earnings yield on the S&P. This means that the valuation situation today is more flagrant than it was in March 2000 when the market topped out.

If the 1.8 spread in March of 2000 was a warning, what about the 2.14% spread that we have today?

Deutsche Bank Alex. Brown's chief investment strategist, Ed Yardeni, uses a variation of the above. He uses the yield on the 10-year T-note and for stocks he uses earnings estimates for the coming four quarters. On Yardeni's method, stocks today are overvalued by about 25%, but the market is still ahead of the fundamentals.

GOLD: I'm going to make it very simple. After surging to a high of 286.60 on May 21 (taking it above both its 50-day and 200-day moving averages), gold plunged lower. As of today's opening (June 4), August gold was just below its 50-day MA, which stands at 267.50. Gold now has a tough job ahead of it. The job – to re-group, and then better its May 21 peak of 286.60.

XAU, the Gold/Silver average, technically, is in better shape, since its 50-day MA (54.86) is above its 200-day MA (50.30). Still, to turn clearly bullish, XAU will have to rally above its May 21 close of 65.70. That won't be easy.

LATE NOTES: The stock market has two problems to deal with. **Technical problem:** The Transports are refusing to confirm the Industrials. **Fundamental Problem:** Valuations are off into space. The S&P is currently selling at **27.5** times earnings while yielding **1.24%.**

NEXT MAILING: June 27, 2001